Remarks by

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THE ROYAL BANK OF CANADA

to the

TORONTO SOCIETY OF FINANCIAL ANALYSTS

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Gentlemen:

I am delighted to be here and to have the opportunity of talking to such a knowledgeable audience about my favourite subjects: banking, and The Royal Bank of Canada.

I am well aware that as professional analysts you are continually engaged in judging the investment qualities of corporations, not only on the basis of their statistics but upon the words and actions of their managements. Naturally, therefore, I welcome the opportunity to talk to you about the way we bankers view our business and how we judge the performance of our own enterprises in it.

I am sure we can all admit that there has not been, up to now, as much expert analysis and evaluation of bank results as there has been of other industries. For one thing, it was only upon the passage of the recent revision to the Bank Act with the resultant clarification of accounting procedures that Canadian banks started to publish some of the information required for a meaningful analysis. For another, I think it is fair to say that few analysts have found the time to familiarize themselves completely with the special conditions of the banking industry, and to learn their way around the various financial data now published by the banks and by other sources such as The Bank of Canada.

All of which leads me to say: "If I were one of you, here is how I would go about looking at the performance and statements of Canadian chartered banks."

At the outset, I must say that there is now an abundance of information available from many sources about the chartered banks in Canada, which might assist you in analyzing the industry and the individual banks.

I am sure you are all familiar with the various submissions to the Porter Commission, as well as the report itself. Then, there are the proceedings of the Standing Committee of the House of Commons on Finance, Trade and Economic Affairs at the decennial revision of the Bank Act, and the new Bank Act itself.

Finally, there is current information published by the chartered banks themselves, by The Bank of Canada, The Dominion Bureau of Statistics, and the Canada Gazette. Overall, there is more detailed information published about the operations of Canada's banking system than is the case in any other country I know of.

Balance Sheet Analysis

For a start, I believe the analyst should follow the usual practice of examining the banks' balance sheets, relating one to another, and each one to the all-bank total.

There are many, many dimensions to be measured in the balance sheet analysis, and we could spend the whole afternoon going into them. Let me pick out a few things I would watch for in particular.

First, of course, look at overall growth. Banking is a high volume, small margin business, and size has a great effect on earnings and profitability. Continuing and steady growth is without any doubt one of the best indications of health in a bank.

Second, examine the composition of the totals on each side of the sheet. What changes are to be seen in the asset mix and the liability mix? The effects of loan and investment policy can be detected by comparing alternative combinations of particular types of assets to the asset total or to particular types of deposit liabilities.

Third, the dimension of time is extremely important. In all of your calculations and analyses, let me urge upon you the importance of looking at the figures over a period of time, rather than at one point in time only. It is completely normal for many of the figures to fluctuate quite widely over a year, half-year or quarter. So basing all of your analyses only upon year-end figures, for example, will almost certainly give you a distorted picture. I would strongly urge upon you the

practice of using averages — taken from the month-end figures during the year, for example.

One instance in which this is particularly important is the calculation of earnings per dollar of assets, which is frequently used as a measurement of management's ability in the profitable use of funds. In our own studies, we use average assets over the year calculated from the monthly returns to the government.

In examining the balance sheet figures, frequently used comparisons include the relationship of loans and investments to total assets, as well as the calculation of either or both as a percentage of deposits. Again, these indicators gain meaning when chartered over a period of time.

Liquidity

In looking even more closely at the assets and liabilities, you must be concerned with liquidity. Liquidity needs of a bank arise not only because of the legal requirements for basic liquidity, but because of the practical needs of cash management, considering fluctuations in various types of deposits, in loan expansion and security purchases. The management of this money position, of course, involves bankers in various alternative methods of adjusting cash reserves, including sale or maturity run-off of securities, cut-back in loaning, and, of course, increased efforts to obtain deposits.

On the liability side, we have deposits and other liabilities, with varying degrees of cost, term, and interest rate volatility. The same goes on the other side of the sheet, where our assets range from cash (which is of course no-yield, maximum liquidity) through various types of securities, some highly liquid but of low-yield, some less liquid but higher yielding, all the way to contract loans such as mortgages and instalment loans with their relatively high yield and lower liquidity.

Incidentally, while The Royal Bank has been active in all loaning areas, the rapid growth in our mortgage portfolio reveals our interest in the development of this area. And I am sure you are aware of our efforts to increase the liquidity of this type of investment by developing a secondary market for mortgage obliga-

tions in Canada. Latest step in this direction was the establishment of RoyMor Ltd., which I shall comment on a little later.

International Business

The extent of each bank's non-domestic resources and commitments may also be compared, and in this connection I may say that the history of The Royal Bank as an international banking organization is a long and successful one. Ever since our founding one hundred years ago in Halifax, we have looked abroad. Our first branch outside Canada was established in 1882 in Hamilton, Bermuda, and today we operate some 130 branches, representative offices and affiliates in other countries. Of the future I would say only that our intention to continue aggressively seeking international business is evidenced by our recent acquisition of ownership interest in two foreign banks — Bank des Activités Economiques in Beirut, and Banque Belge pour l'Industrie in Brussels. Suffice it to say we are looking at other countries and areas as well.

Returning to the balance sheet, it is, of course, possible to measure each bank's asset-capital ratio. Analysts often ask what a proper standard of capital adequacy should be. All I'm going to say is that in this — which is a judgment matter — each bank must make its own decisions! The latest revision of the Bank Act does, however, give us more flexibility in arranging our capital structure since we can now issue debentures when we feel conditions are appropriate.

Operating Statement

Let us now turn to the operating statement, or more properly, the Statement of Revenue, Expenses and Undivided Profits.

These operating statements, as now provided by the banks, detail the sources and uses of the revenue dollar, and give the analyst the opportunity of examining the rates of growth of the various types of income and expenditure. I would caution you again, here. If you are calculating the yield earned on various assets,

it would be more valid to look at a compiled average of the earning asset being examined, and compare *that* with the revenue earned, rather than calculating revenue as a percentage of the spot asset figure taken from the year-end annual statement.

On the whole I think the revenue and expense classifications are self-explanatory, with the possible exception of the figure described as "Other operating expenses, including provision for losses on loans based on estimated five-year average loss experience." As indicated, this includes the reporting bank's provision for losses on loans, based on a five-year average. The calculation of this provision takes into account the loss experience from the current year's operations as well as those of the four previous years. The average derived therefrom is charged as an expense.

It is in the nature of banking that loss experience fluctuates widely. In some years there are unexpected losses, and in others unexpected recoveries. In relating this to the amount included in the "other operating expenses" figure, we know that in some years actual losses will be under the five-year average charged, and in other years actual losses will substantially exceed the amount charged. The difference is either added to or deducted from the balance carried forward from the previous year in the Statement of Accumulated Appropriations for Losses, of which I will speak again in a moment.

Balance Of Revenue

From a management viewpoint, and also from the analyst's viewpoint, by far the most useful single figure on the revenue and expense statement is the Balance of Revenue, which represents operating profit after all charges except the appropriation for losses and the provision for income taxes. This figure is generally recognized as one of the best measures of profitability, the best indicator to compare one year's earnings against another, and also the most useful tool for comparing one bank's earnings performance with another. In blunt terms, gentlemen, this figure is hard fact, while the figures that go below it on the operating statement are largely determined by management

decision and policy.

This brings us to what is probably the most discussed, yet most misunderstood entry in the operating statement, the Appropriation for Losses. We in the Royal Bank are particularly aware of some of these misunderstandings, because our recent quarterly reports have shown considerably-increased estimates of the amounts we should set aside for the year-end transfer into Accumulated Appropriations for Losses. One of the results has been that a few shareholders, and some analysts, have mistakenly assumed that we had set these amounts high because we actually expected to have very large losses on loans during fiscal 1968 or in the near future.

Because of this, I would like to leave the operating statement for a few moments, and refer to the Statement of Accumulated Appropriations for Losses.

First, entries in this account are made only once a year, at the end of the year. The provisions shown in our quarterly operating reports can thus only be estimates.

Second, while we must follow the terminology stipulated by government authorities, it is my own opinion that the phrase "Appropriation for Losses" is an inadequate one, which deserves amplification. This account is more than just a specific provision for losses on loans, it is a much broader contingency reserve.

No Need For Apology

On this subject, I should stress that I feel very strongly that Canadian bankers have no reason to apologize for strength in their contingency reserves, nor for adding to them as risk assets rise. After all, the long history of stability in the Canadian banking system rests upon such prudent provisions. As a senior banker pointed out to this very audience in January, it would only take something like a 2% over-all loss on our risk assets to wipe out the general contingency reserves.

Further, while Government of Canada and Provincial securities are by law carried on our books at amortized value, in periods of high interest rates the market value of these securities is reduced substantially below book. Thus if we were to sell any of these during

such a period, we would have an actual loss which would be charged to our Accumulated Appropriations. Thus, bond market conditions are a factor in our deciding on the desirable level of appropriations for losses.

All other investments must be reported at market value, and with the rapidly rising interest rate structure of recent years our holdings of certain securities (municipal bonds, for example) have, of course, dropped in market value. Most of these securities are held to maturity, so that there is ultimately no capital loss, but in the meantime the difference between cost and market must be charged to Accumulated Appropriations for Losses. These entries are reversed as and when their market value improves or the bonds mature at par.

There is another important entry in the Statement of Accumulated Appropriations for Losses and I refer particularly to the last item: "Other profits, losses and non-recurring items, net." Here are charged our foreign exchange gains or losses. We do not maintain a position in foreign exchange, but try to stay as close to a 'flat' position as possible, offsetting purchases with sales. So we normally have no losses from this. But we do have capital assigned to our branches, subsidiaries and affiliates in other countries — those in South America, for instance. With the devaluations that occur there from time to time we must write down our capital and charge the difference to Accumulated Appropriations for Losses. As you can see — and I want to stress this — the Appropriation for Losses covers many things besides losses on loans. Therefore, I repeat that the amount appearing opposite the heading "Appropriation for Losses" in the revenue and expense statement does not necessarily indicate that losses to this extent are either imminent or expected.

My remarks on ways of analysing the various statements published by Canadian banks, as well as some of the points I wish to make a little later will be illuminated by the little folder of charts which has been distributed among you. (*See inside back cover of booklet.*)

To comment first on the chart headed *Assets*, you will see, how large, relative to the whole, are our risk assets. This is banking, gentlemen, and unlike some other industries, fixed assets are quite small in relation

to the total. It is well to remember this not only in the context of the need for reserves, but in judging the validity of such performance measures as return on assets.

Deposit Mix

Turning to the chart marked *Deposits*, you will note that a substantial change has occurred in the character of our deposit mix in recent years. In the chart, we have broken deposits into two categories, chequable and non-chequable. The top portion includes term money, deposit receipts and the like, and our new bonus savings accounts. This is rate-sensitive money. The lower portion is chequable deposits, including regular savings accounts, current accounts and personal chequing accounts. What the chart points up, I believe, is a considerable shift into the rate-sensitive instruments — which are also, of course, more expensive sources of funds for the bank.

In 1963, something like 90 per cent of our deposits were in accounts relatively less sensitive to changes in interest rates. Today, in contrast, this type of deposit accounts for less than 60 per cent of the total. This reflects a number of things, of course, including increasing industrial expertise in cash management, the introduction of our new Bonus Savings Account, and greatly increased competition between banks and other financial institutions for time deposits. The implications of shifts like this are quite significant.

Finally, I would direct your attention to the charts showing the sources of The Royal Bank's revenue dollar and the distribution of our expense dollar. As you can see, by far the largest source of revenue is the loaning business, which provides more than two thirds of all revenue. Income from securities and other revenues together account for less than a third. On the other side of the coin, by far the largest single component of the expense dollar is interest paid on deposits. This expense in 1967 represented 41.4 per cent of The Royal Bank's gross revenue.

This brings up the whole question of interest rates, interest rate trends, and the art and science of margin

control, for what comes out of the charts we have just looked at is clearly the old maxim that a banker lives on the "spread" between what he pays for money and what he can get for it.

Oddly enough, this simple and basic fact is often forgotten in discussions of interest rates, and there are those who mistakenly believe that the chartered banks "set" their interest rates on loans almost unilaterally. In fact, of course, the banks work within an interest rate structure, a *market*, which is mostly determined by others. As I said before, the banker (today as in 2,000 B.C.) derives the bulk of this earnings from the differential between what he must pay to attract deposits, and the amount he can charge for loans. In our competitive economy, both sets of rates are determined basically by the market — by the supply of and demand for money.

As you know, one of the major results of the recent revision of the Bank Act was the removal of the interest rate ceiling, which brought a considerably increased measure of freedom and flexibility for the chartered banks not only in their loan rates, but in their deposit rates. The effects of this upon banking in Canada have been profound.

Premium On Management

You might almost say it is a "new ball game" — one which puts a premium more than ever upon the quality of management.

While on the liability or deposit side we can at any point in time calculate an average cost of funds, the pool of deposits whose cost we must consider is actually ever-changing in terms of its composition. It includes short term money, highly volatile and high in cost, but usually available on short notice if you need it and are willing to bid high enough for it. At the other end of the scale you have personal savings deposits, usually fairly stable, relatively steady in cost, but hard to attract in a hurry. In short, you have a *mix* of types of deposits of varying interest rate flexibility, varying term, varying cost, varying availability. Certain parts of this pool respond quickly to changes in the market, others are less sensitive. One of the trends in this

connection is, of course, evident in the deposit chart we looked at a minute ago.

Frequently, this results in some "lag" behind the market. Yet, obviously, we try not to be much behind, because if our rate is low, customers will deposit their money across the street in some other institution. Also, if *reductions* in our deposit rates were to lag too far behind, our overall cost of funds would be too high and we could not lend money at rates which would leave us a reasonable differential. Thus the problem of managing the liability mix is one of setting the rates, amounts, and terms of our various deposit instruments in such a way as to provide us with sufficient funds for an expanding loaning business, with the proper measure of liquidity, and at an overall average cost which will leave a satisfactory "spread".

On the other side of the ledger, a bank's asset mix requires even more delicate management, because of the wide variety of ways in which our funds can be employed. It ranges, in fact, all the way from high yield, long-term contract loans, down to highly liquid low-yield securities. The trick is to keep these assets in proper balance, so as to give us a reasonable average yield. And again, it is a problem of flexibility — a question of how close we can or should stay to the rises and falls in money market rates.

Responsible Role

Finally, there is another powerful consideration in the management of a bank's asset mix, and that is the clear responsibility of national banking institutions like The Royal Bank to give adequate and balanced attention to the needs of the many sectors of our society. This means that on many, many occasions we are obliged to weigh regional and other considerations even more heavily in the scale than short-term profitability. We sometimes sacrifice profits in the short run in order to secure our long range position and profit potential by supporting propositions which, in themselves, are not that attractive.

In your analyses of the results of the various banks, I suggest that you pay close attention to the success with which each bank increases its flexibility and respon-

siveness to the market so as to achieve and maintain adequate spreads. The factors involved are the composition of the deposit mix, the composition of the asset mix, the overall volume (because increases in volume may result in absolute increases in earnings despite narrowed margins), and the trends in income from loans and interest paid on deposits, as compared to each other. I am confident, gentlemen, that we in The Royal Bank will measure up very well by this standard.

Being competitive and, at the same time, maintaining our spread, whether interest rates are rising or falling, whether money is tight or not — this is all not so very new. Basically, it has always been at the heart of the banking business.

Significant Shift In Emphasis

Yet some of us in Canadian Banks believe that this is going to change, or at least that there is going to be a shift in emphasis. And this shift in emphasis — even a slight one — could be very significant to the earnings and profitability of banking.

The factors we have just been examining in the context of margin control are all tied more or less closely to monetary conditions. And while every business endeavour is affected by general economic conditions, some bankers are examining profit sources less closely affected by short-term changes in monetary conditions and more amenable to long-range planning.

It happens that this fits closely with some other considerations which are more and more current in banking today, considerations which can perhaps be best summed up by saying that Canadian banks have recently been asking themselves the question which was faced by the railways some years ago. We are now asking ourselves the crucial question: "What business are we in?"

I am sure you are all familiar with the case of the railways — it has been propounded many times. Fifty or sixty years ago, the railway industry in North America was considered invincible, solid as the rock of Gibraltar. And the railways were no slouches in management techniques — some were using the most

advanced approaches available. Yet some made what we now see to be a basic mistake. They answered the question "What business are we in" with too narrow a concept. They thought they were in the business of running trains at a profit, or to broaden it just a little, they considered they were in the business of transporting goods and people *by rail*.

Well, we all know that the railways which continued to view their function this way have had a pretty rough time of it. A much better answer was, of course, that they were in the business of *filling customer's needs for transportation*, which involves moving anything from A to B in the way most suited to the customer's needs. This is why some railways are concerning themselves not only with trains, but with aircraft, trucks, ships . . . even pipelines for moving bulk goods, and lines and microwave networks for transporting information.

"What Business Are We In?"

What has all this to do with banking? Well, as I said just now, many of us in Canadian banking are now asking much the same question — what business are we in?

On the one hand, the traditional — and perfectly proper — answer is that the banks are basically in the business of gathering deposits and making loans, with a number of money transfer services added to support the deposit-gathering function.

On the other hand, it is our view that we are in the business of *filling the customer's needs for financial services*. This concept, I might say, has its roots in the business philosophy which says that the most fruitful way of looking at a business is not to think of the enterprise as a goods or service-*producing* entity, but as a *needs-satisfying* entity. In other words, this is a *customer* orientation based on recognition of the fact that the *customer* is the source of all profit.

The development of this concept means that a bank should be in the business of providing financial services which meet the following criteria: services the customers need and want; services which fit well into the bank's pattern of business and which it can perform efficiently

and at low cost; services which it can provide at a reasonable profit. This is quite different from the idea, once current, that banks should only provide those services which would specifically help it gather deposits and make loans.

Services For Fee

In practical terms, what does all this mean? It means possibly that some banks may begin to develop more services for fee, including both services to individuals and families and services to businesses and corporations. We offer some of the latter now — computer payroll services and account reconciliation, for example.

It means also that we in the banks are going to make much heavier use of the computer, because computers enable us to offer services which up till recently were either too expensive or just not possible.

The profit implications of these new approaches are several. For one thing, an even heavier responsibility will be laid upon bank management carefully to *plan* profitable operation, rather than relying on events to provide profits once a structure has been set up. It means also that bank revenues may become propertionately somewhat less dependent upon the size of the balance sheet and more dependent upon the quality of management's decisions in organizing, innovating, planning and controlling the operation, and in motivating and developing skilled and committed staff.

Innovation

I am not going to take time to discuss the "cashless, chequeless society", or even the "less-cheque" society. But I would point out that inherent in these ideas is the assumption that the banking business is broader than the deposit and loan function, that it involves the development and marketing of *services* as separate and self-sufficient profit sources. And it also assumes that it is a bank's business to *innovate*.

While the volume and profitability of such services-for-profit will, of course, be affected by swings in

Canadian business activity and the economy generally, one might expect that a proportionate increase in this type of revenue would result in a somewhat smoother and more manageable (in the true sense of the word) profit performance than has traditionally been the case with Canadian banks.

A moment ago I said that it is a bank's business to innovate — to apply expertise, imagination and ingenuity to the task of developing new and better ways of serving customers by discovering and filling their needs. I feel that we in The Royal Bank have reason for a certain amount of pride in our record in this regard, and I would like to refer briefly to a number of examples.

The creation of RoyNat is one. There was a real need for industrial term loans of a type which the banks could not properly make at the time — so we found a way, in co-operation with others.

Our mortgage program is another example. We were — and are — convinced of the need for extensive mortgage lending, not only in the large centres, but in smaller places where the big institutional mortgage lenders are not so well represented, and we were determined to find a way to fill this. In examining the problem, we saw that unless we could roll the funds over, our possible contribution would be limited. So we bent our efforts to encouraging the growth of a secondary mortgage market in the country through the establishment of a mortgage banking program and more recently, through the creation of RoyMor Limited.

Another example is in the creation of International Capital Corporation, announced just yesterday. Here a need which could not be filled directly is being approached through the creation of a specialized corporation in co-operation with others.

We are pleased that our consumer-type Termplan loans have met with such wide acceptance. Also, our recently announced Farmplan loan program is, we think, a fine example of a program tailored to fit the specific needs of the agricultural community.

In the area of service to individual clients, we encouraged the establishment of RoyFund Ltd., giving customers a convenient way to diversify their savings through a mutual fund available at our branches.

Computer Technology

We have been increasing our use of computer technology apace, following the logical view that our business is very largely that of processing information, and modern computers are highly efficient tools for doing this. Indeed, we have been told that, apart from the federal government, The Royal Bank is certainly one of the country's largest information processors. As I have said before, computers do two things for us — they allow us to do things which would otherwise be impossible, and they remove more and more of the load of routine mechanical tasks from people, allowing the people to devote more time to uniquely human functions — applying their judgement, using their imagination, being courteous, friendly and helpful to people. Computers have no judgement, no imagination, no courtesy, no friendly feelings, but they *can* give people more time to use these uniquely human attributes.

Our use of electronic data processing equipment and methods has grown and is growing very rapidly. We were the first chartered bank in Canada to introduce on-line, real-time account-handling through terminals at the teller's wicket.

Credit Cards

I could go on and on with tales of innovations, for I find them fascinating, but I will add only mention of Chargex, the credit card plan recently launched in Montreal and Toronto by three other banks and ourselves.

Some people have asked us what we are doing in credit cards. "Is that banking?" They ask. Let me retort this way: A credit card plan is two things, a money-transfer mechanism, and a means of lending money. We feel strongly that these are both *banking* functions. That both merchants and members of the public agree with us is testified to by the fact that, though it is early yet, the acceptance of the Chargex scheme is already well beyond our expectations.

All of these new things are designed to help us give

the Canadian people better service, and through giving them better service, to enhance our growth and profitability. And, as any of you who have read our recent operating statements knows, we have been able to make substantial strides in improving profit performance. Indeed, the absolute dollar figures have tended to reinforce the ancient misconception that the banks are "rolling in money". Well, with $8 billion in assets we may be rolling in money, but it's not ours — most of it belongs to other people, our depositors.

Profit Performance

We have been pleased with the recent improvement in our earnings, particularly in the year to date. But despite the current improvement, we are still not satisfied with our earnings performance. You will recognize the problems of establishing yardsticks for comparison of a chartered bank's profitability with that of corporations operating in other industries. It is also difficult for us to evaluate our results vis-à-vis those of banking institutions in the United States and other countries because of substantial differences in our respective services and variances in accounting practices and income tax regulations. We have, however, studied this matter intensively and have reached the overall conclusion that we are not operating as profitably as our American counterparts or, for that matter, as profitably as leading corporations in many other industries in Canada. We are intent, therefore, on continuing our efforts to attain a more satisfactory rate of return, on both our shareholders' equity investment and on our total asset position.

Return On Assets

You may be interested in knowing that our studies suggest that return on total assets, calculated as Balance of Revenue divided by total assets, is the simplest and best overall method of comparing profit performance, as between Canadian chartered banks. This ratio is felt to be more meaningful in banking than in many other industries because fixed assets represent a

relatively small proportion of a bank's total assets and while, as I discussed earlier, the balance of revenue figure is determined before deduction of Appropriation for Losses and provision for income taxes, it does provide the most meaningful basis of comparison between banks.

Gentlemen, in summing up, let me express my gratitude to you for giving me this forum to talk about my favourite subject - banking. This matter of analysing bank performance is a complicated and difficult matter, but for us bankers, never dull. I hope it hasn't been dull for you.

Let me leave one thought with you.

If the basic purpose of banking is to provide financial services that the community needs and wants, and long-term profit is to be the measure of our success in fulfilling this purpose of providing service, as well as a necessity for the continued existence and health of our organizations, then it must be the concern of bank management to devise the best means of earning good profits *through* service.

Banking Is A "People" Business

It is my belief that the key to success in this lies in our *people*. Indeed, in banking, a service industry, the premium is on people, joined together so that the whole is more than the sum of the parts. This extra dimension. which makes their efforts more than an exercise in addition, cannot be found in digits, in computers, in branch buildings, or cash drawers. It is found in the people who make up an organization, in the common purpose which binds them together, and in the satisfaction of the customers they serve.

Any true analysis of the condition and performance of a bank must take this into account, because in the end, it is our most important asset.

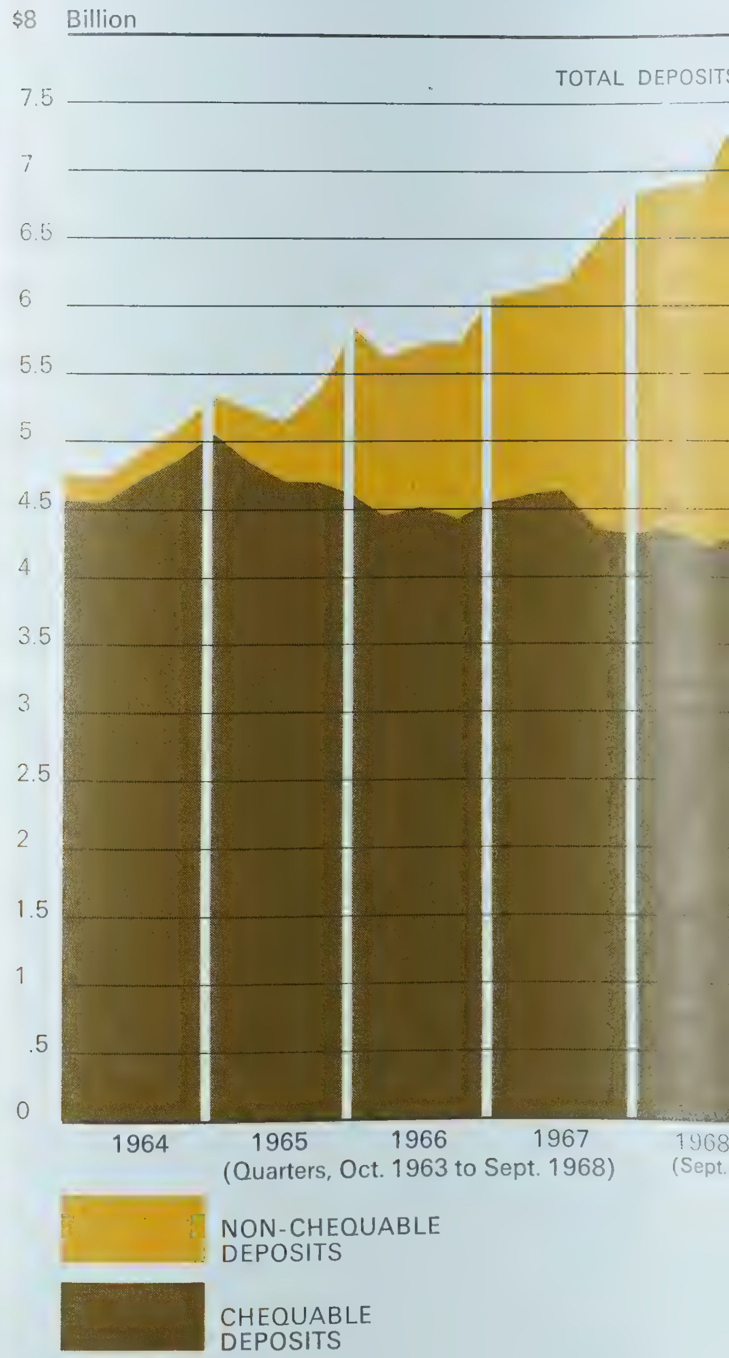
CHARTS

CHARTS

ROYAL BANK

ASSETS

DEPOSITS



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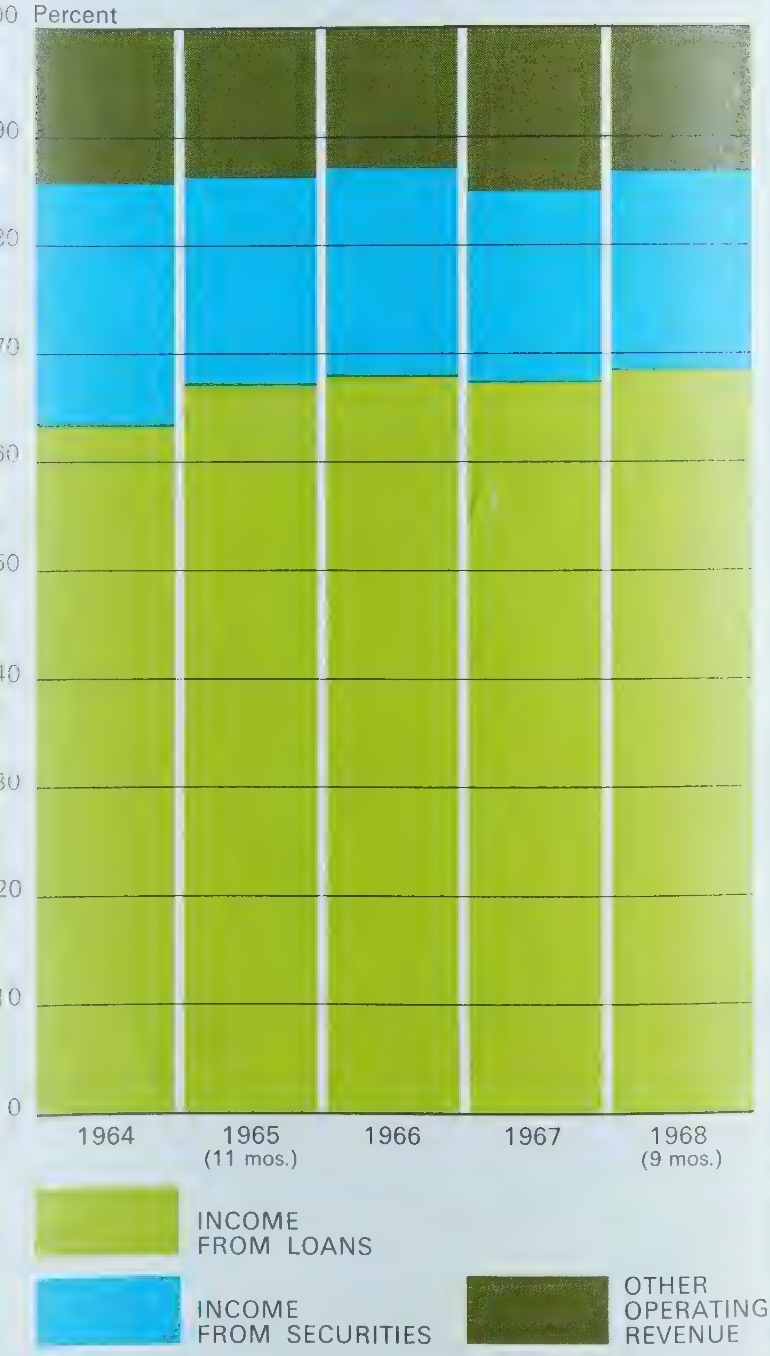

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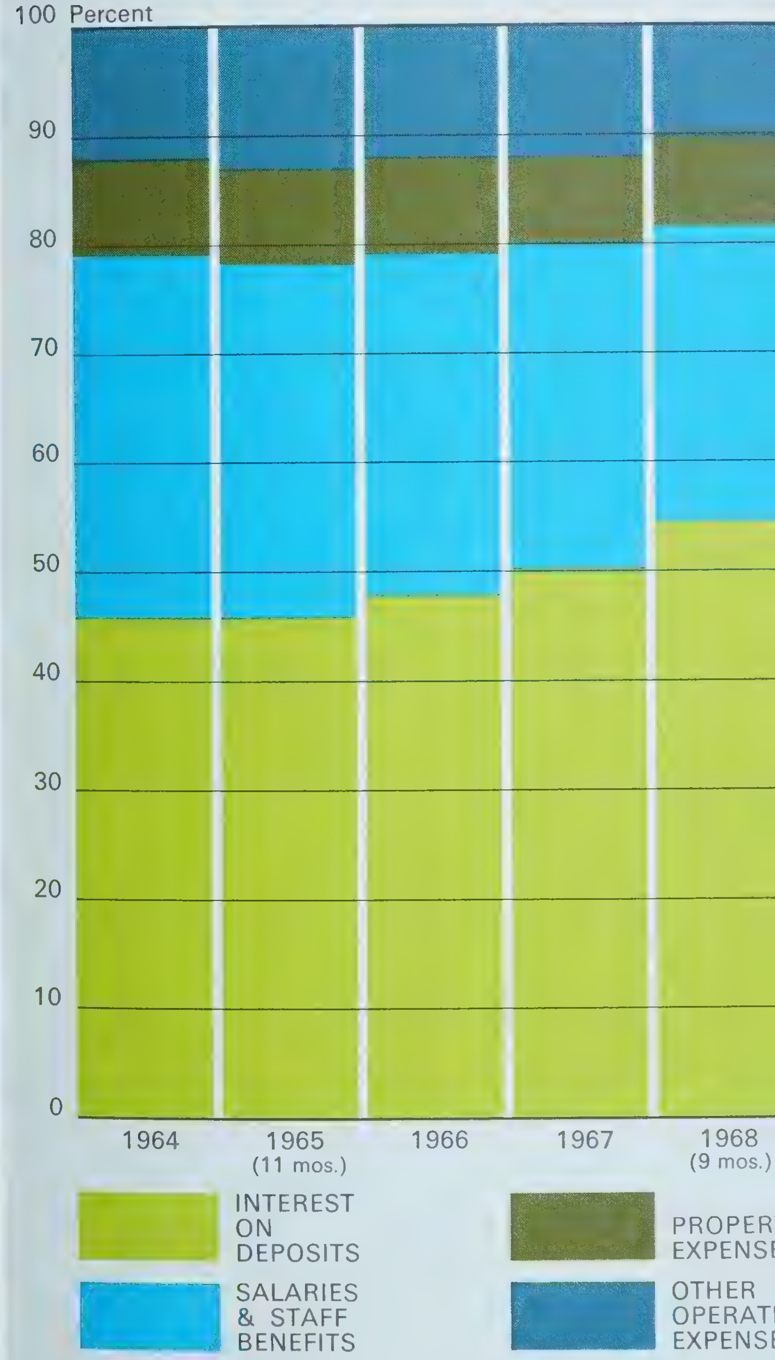
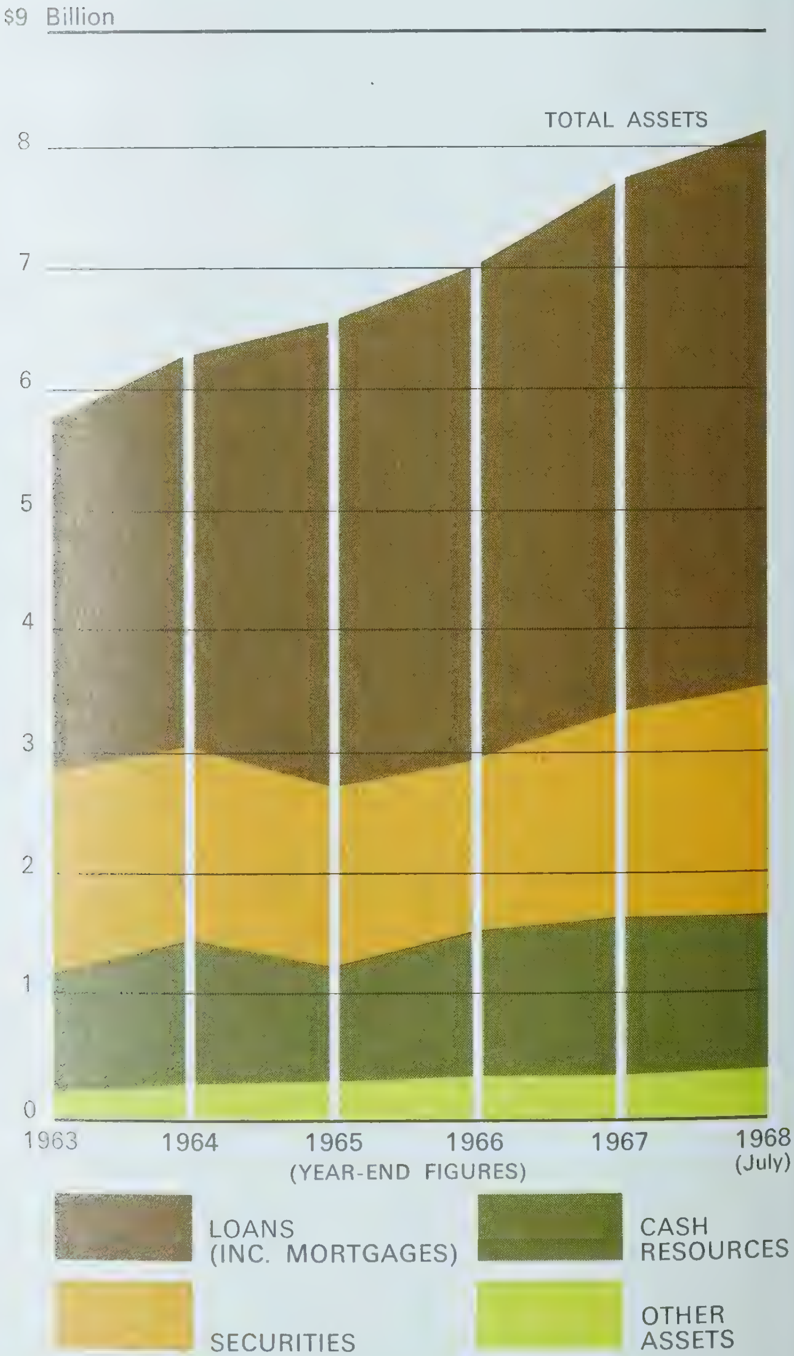


ROYAL BANK

ASSETS



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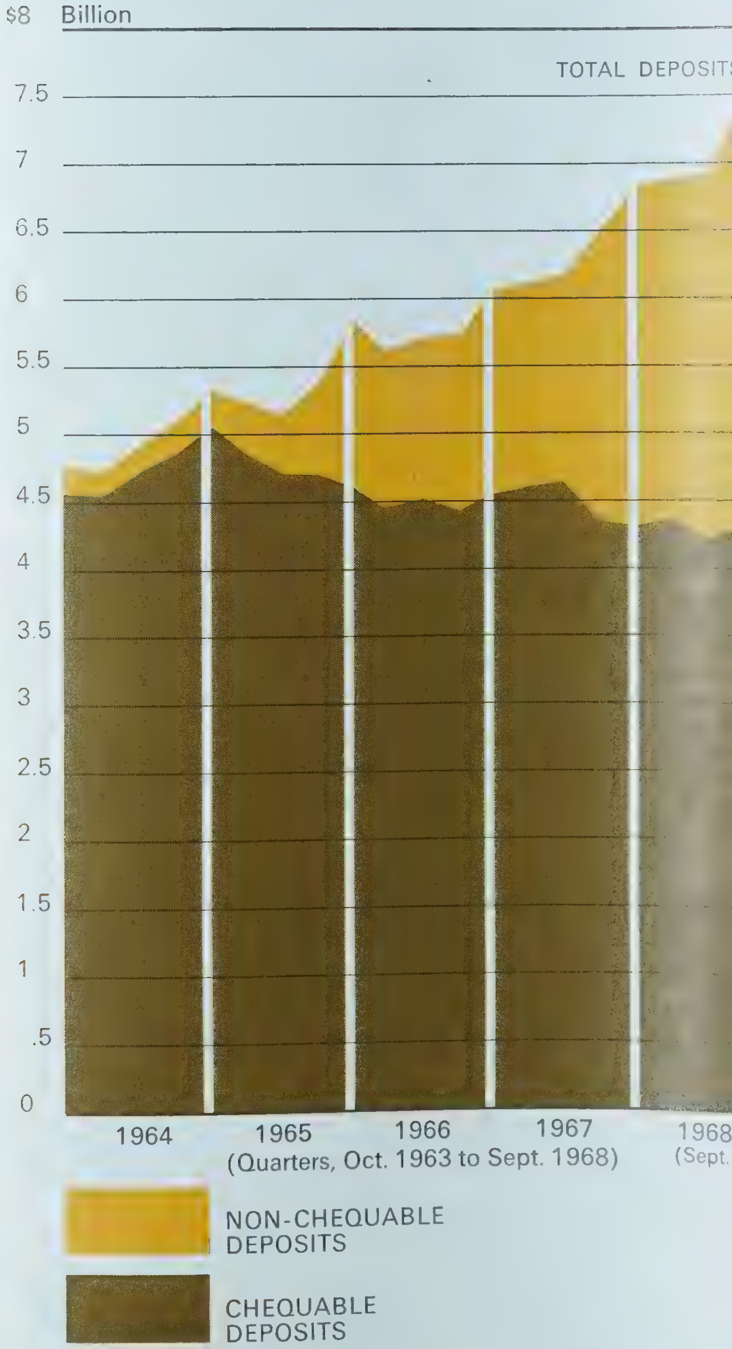

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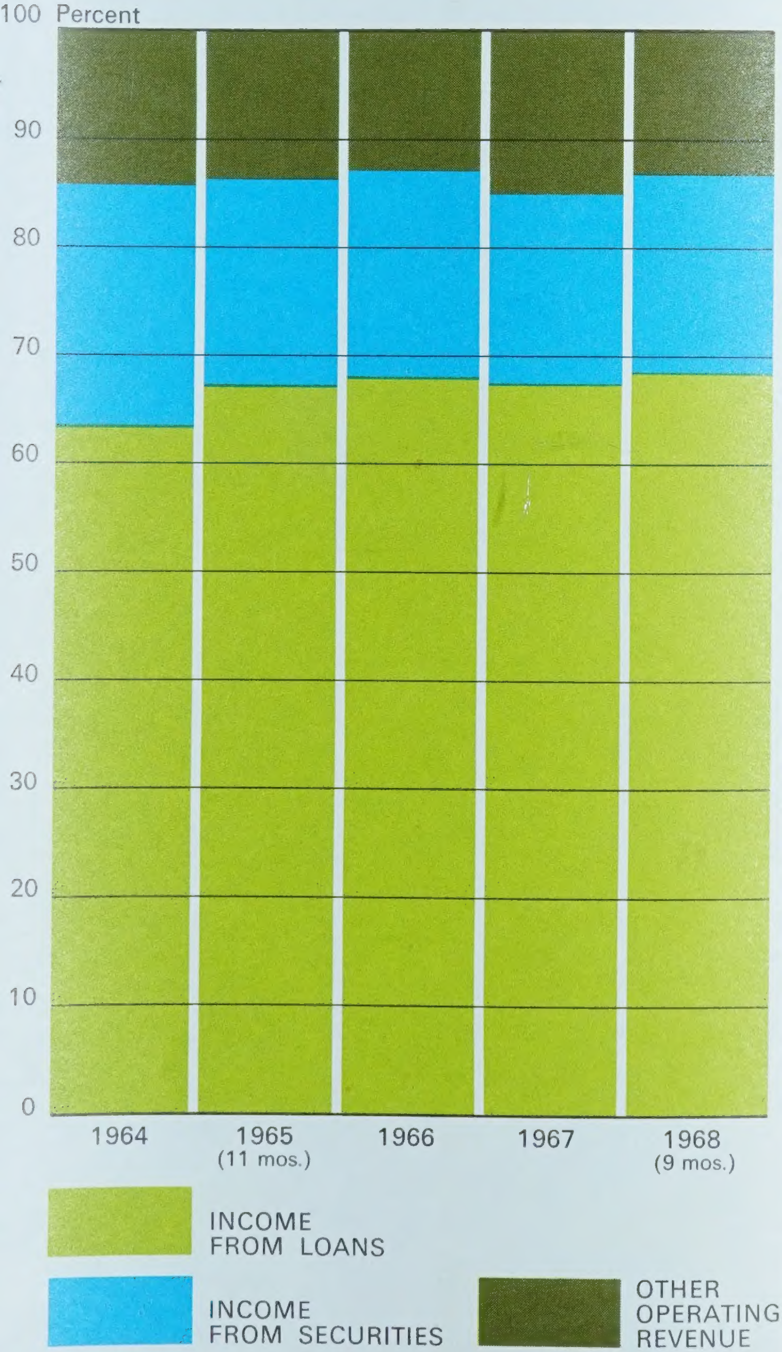

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